CHAPTER X

RISK ASSOCIATED WITH TRENDS IN THE TREATMENT OF SOVEREIGN DEBT IN BILATERAL TRADE AND INVESTMENT TREATIES

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A. Introduction

There is a growing trend in Free Trade Agreements for the inclusion of provisions that subject policy towards the financial sector to legal disciplines enshrined in trade and investment agreements and to the associated dispute- settlement mechanisms. This trend places limits on the use by developing countries of several tools designed to build and preserve stable and healthy financial sectors responsive to national development priorities and supportive of trade. The limits are capable of increasing developing countries' vulnerability to financial and debt crises.

B. Sovereign Debt in Bilateral Trade and Investment Treaties

In bilateral Free Trade Agreements recently negotiated by the United States Government a controversial issue has been the insistence of the United States on pursuing inclusion of clauses that would apply to sovereign debt issued by the parties principles such as National Treatment and Most-Favored-Nation (MFN) Treatment which are part of bilateral investment treaties and of GATT/WTO rules for trade in goods and services.

A review of some recent treaties reveals at least two different approaches to the treatment of sovereign debt.

1. Sovereign Debt Explicitly Excluded from Application of the Principles

Under NAFTA, investment covers a sweeping array of types of ownership interests, including loans and securities. However, in conformity with Article 1416 in the section on Financial Services, "investment means "investment" as defined in Article 1139 (Investment Definitions), except that, with respect to "loans" and "debt securities" referred to in that Article: (a) a loan to or debt security issued by a financial institution is an investment only where it is treated as regulatory capital by the Party in whose territory the financial institution is located; and (b) a loan granted by or debt security owned by a financial institution, other than a loan to or debt security of a financial institution referred to in subparagraph (a), is not an investment;"

To this is added the following: "for greater certainty: (c) *a loan to, or debt security issued by, a Party or a state enterprise thereof is not an investment" (author's italics).*

Therefore, under NAFTA, sovereign debts are explicitly excluded from the definition of investment.

2. Sovereign Debt Explicitly Included within the Scope of Application of Investment Principles

In the 2003 United States-Chile Free Trade Agreement (FTA) specific principles on investment are explicitly applicable to sovereign debt. The United States-Chile FTA contains a broad definition of investment based on the following standard adopted by the United States in its most recent Bilateral Investment Treaty (BIT) Model.[129]

"Investment means every asset that an investor owns or controls, directly or indirectly, that has the characteristics of an investment, including such characteristics as the commitment of capital or other resources, the expectation of gain or profit, or the assumption of risk. Forms that an investment may take include:

- An enterprise;
- Shares, stock, and other forms of equity participation in an enterprise;
- Bonds, debentures, loans, and other debt instruments;
- Futures, options, and other derivatives;
- Rights under contract, including turnkey, construction, management, production, concession, or revenue-sharing contracts;
- Intellectual property rights;
- Rights conferred pursuant to domestic law, such as concessions, licenses, authorizations, and permits; and
- Other tangible or intangible, movable or immovable property, and related property rights, such as leases, mortgages, liens, and pledges; but investment does not mean an order or judgment entered in a judicial or administrative action…"

This definition generally includes "bonds, debentures, loans and other debt instruments".[130] In what represents a significant departure from NAFTA, the treaty explicitly makes the agreement's

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[129] This definition has become standard blueprint for the US negotiating position in treaties. See United States 2004 Model BIT, Art .1

[130] Usually with a footnote that clarifies "Some forms of debt, such as bonds, debentures, and long-term notes, are more likely to have the characteristics of an investment, while other forms of debt, such as claims to payment that are immediately due and result from the sale of goods or services, are les likely to have such characteristics."

provisions applicable to sovereign debts issued by the Chilean Government.[131] The same rules are contained in the Central America Free Trade Agreement (CAFTA).[132] Thus, the United States-Chile FTA and CAFTA make National Treatment and MFN Treatment applicable to sovereign debts issued by the Governments of the countries involved.

3. The "Elliptic" Inclusion of Debt in the United States- Uruguay FTA

The United States-Uruguay FTA (signed in 2004) raises an interesting question because its provisions could lead to re-interpretation of previous treaties. The FTA contains the standard definition of investment as including "Bond, debentures, other debt instruments and loans" It also contains, in Annex F, a clause with language similar to the first part of the NAFTA article above.[133]

Up to this point of the text, although there is no explicit exclusion as in the NAFTA supplementary clause, the agreement seems to imply that sovereign debt is excluded from the definition of investment.

However, this does not appear to be the case. Annex G of the United States-Uruguay FTA headed "Sovereign Debt", reads as follows:

> "1. No claim that a restructuring of a debt instrument issued by Uruguay breaches an obligation under Articles 5 through 10 may be submitted to, or if already submitted continue in, arbitration under Section B, if the restructuring is a negotiated restructuring at the time of submission, or becomes a negotiated restructuring after such submission."

This would appear to mean that sovereign debt is, indeed, included in the scope of the definition of investment for the purposes of the Treaty. It also would open the way for the interpretation that, absent an explicit exclusion, sovereign debt is considered to fit into the scope of the definition of investment. This could have the consequence of leading to an expansion of the scope of the term, "investment", in treaties worded similarly to the United States-Uruguay FTA, such as the United States-Singapore FTA.

C. Implications for Sovereign Debt Problems of Including National Treatment and MFN Treatment in FTAs

What are the possible implications of applying National Treatment and MFN Treatment to sovereign debt?

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[131] See Annex 10-B (Annex to the chapter of the treaty that deals with investment): "The rescheduling of the debts of Chile, or of its appropriate institutions owned or controlled through ownership interests by Chile, owed to the United States and the rescheduling of its debts owed to creditors in general are not subject to any provision of Section A other than Articles 10.2 and 10.3" Articles 10.2 and 10.3 in the Treaty refer to National Treatment and Most- Favored-Nation Treatment.

[132] See also Ugarteche (2004, 14-18 and 34-35).

[133] Art .4 reads:
"(b) Investment means "investment" as defined in Article 1, except that, with respect to "loans" and "debt instruments" referred to in that Article: (i) a loan to or debt instrument issued by a financial institution is an investment in a financial institution only where it is treated as regulatory capital by the Party in whose territory the financial institution is located; and(ii) a loan granted by or debt instrument owned by a financial institution, other than a loan to or debt instrument of a financial institution referred to in subparagraph (b)(i), is not an investment in a financial institution".

These principles were originally developed in different historical contexts. National Treatment featured from the first half of the twentieth century onwards in treaties of friendship, commerce and navigation (FCN treaties), i.e. bilateral treaties covering miscellaneous subjects such as access to ports, tariffs, the powers and responsibilities of consuls, and protection against appropriation. The last of these headings typically included provisions concerning national treatment, i.e. guarantees of non-discriminatory treatment of foreign firms. MFN clauses were included in reciprocal trade agreements negotiated between the United States and various countries under a program legislated in 1934. Under the MFN clauses included in these agreements each of the parties bound itself to extend to the other tariff concessions at least as great as those extended to the most favored nation with which it traded. Both National Treatment and MFN Treatment were included in the GATT as principles applying to trade in goods.

The extension of National Treatment and MFN Treatment to other subjects is neither straightforward nor uncontroversial.[134] Indeed, their extension to sovereign debt raises issues that could be more harmful to developing countries than those considered under their traditional application to foreign investment. A discussion of a number of these issues follows:

1. Dismantling Tools Needed for the Recovery of the Local Economy in Post-Crisis Situations

The application of National Treatment to sovereign debt would restrict the ability of the debtor Government to take certain policy measures aimed at the recovery of the local economy in the aftermath of financial crises. National Treatment in this context means that foreign creditors are offered treatment in debt restructurings no less favorable than that offered to domestic creditors.[135]

However, there are several reasons why a country restructuring its sovereign debt after a financial crisis might need to resort to offering preferential conditions to domestic creditors.

- In a financial crisis, domestic creditors often suffer a *double adjustment*. First, they are typically forced to accept a “haircut” on their claims, which means that the value of their loans are reduced by a certain percentage. Secondly, they often suffer costs related to the internal adjustment, such as high interest rates. In fact, the impact of debt restructuring on domestic capital markets and, in turn, on the resumption of growth and repayment capacity needs to be taken into account in assessing the consequences of debt crises (Machinea, 2004: 188)..”
- Dealing with domestic before foreign debt might also allow the Government to return rapidly to domestic capital markets during what is likely to be a sustained interruption in its access to international capital markets (IMF, 2002: 13).
- The debtor may also need to accord priority to domestic debt in order to protect the financial system. The IMF has said that “the restructuring of certain types of domestic debt may have major implications for economic performance, as a result of its impact on the financial system and the operation of domestic capital markets” (IMF, 2002: 13). Sovereign debt restructuring typically has a double impact on the financial system. On the one hand

[134] See Khor (2002), who states: “It is certainly not clear that the principles of the WTO (including National Treatment and Most-Favored-Nation treatment) that apply to trade in goods should apply to investment, nor that, if applied, they would benefit developing countries.” See also Chang and Green (2003), Action Aid (2003), Oxfam International (2003).

[135] This is important in the context of the developing country signatories of CAFTA, since, with the exception of Honduras, an important share of public debt in all these countries is owed to domestic creditors. In some of them, like Costa Rica, domestic debt is actually higher than external debt.

financial institutions are weakened by the impact on their capital levels of the reduction in the value of bonds. On the other hand, debt restructuring is associated with a general increase in uncertainty, which can inflict widespread damage on the creditworthiness of firms (Machinea, 2004: 188-189). Thus, in such cases special treatment to domestic debt may enable the debtor to protect "a core of the banking system by ensuring the availability of assets required for banks to manage capital, liquidity and exposure to market risks" (IMF, 2002: 13).

- A sovereign debtor may also need to accord special treatment to domestic debtors for the same reasons that can lead it to accord special treatment to national sectors and industries as part of a national development strategy and the achievement of development goals.
- In the IMF's view sheltering domestic investors from the full impact of debt restructuring may be necessary in order to "garner support for an ambitious adjustment program" (IMF, 2002: 13).

2. Preventing the State from Paying Salaries and Pensions in Debt Crises

The application of National Treatment to sovereign debt means that the Government will be unable to prioritize domestic debt associated with meeting wages, salaries and pension obligations. In other words, the Government is bound to treat these debts in the same way as foreign debts held by transnational banks and institutional investors. If its resources are enough to cover only a portion of its debts, the state will not be able to choose to direct those funds to meeting these priorities, at least not as long as it does not devote equal amount for payments to foreign creditors.

Unlike an indebted private company, an indebted sovereign has human-rights obligations and social responsibilities towards its people. This means that, in dealing with sovereign debt, there are issues that cannot be addressed by strict analogies with bankruptcy principles applicable to the private sector. Thus proposals of civil society for a rules-based framework have typically called for recourse to analogies with frameworks which accommodate the overall mission that the state is expected to fulfill. Such frameworks include Chapter 9 of United States Bankruptcy Law applicable to municipalities. Even the IMF's much-criticized Sovereign Debt Restructuring Mechanism proposal excluded "Wages, salaries and pensions" from its application (IMF, 2003: 24).

3. Reducing the Leverage of Debtors in a Debt Restructuring

By first gathering the support of domestic creditors a Government can acquire substantial clout for the negotiations over debt restructuring with other creditors. The offer of preferential conditions to these domestic creditors can be critical in this context. Thus if the principle of National Treatment is applied to sovereign debt, this avenue for the indebted country to strengthen its negotiating position is effectively foreclosed.

The offer of preferential conditions to domestic creditors was crucial to enhancing the Government's leverage in Argentina's negotiations with its creditors after its December 2001 default. In September 2003 the Government released its initial proposed conditions for debt restructuring, which included a 75-per-cent haircut for bond holders. The Government contended that this was the size of the reduction that would enable it to recover sustainable economic growth, while ensuring that its promises of payment were kept. Some groups of bond-holders quickly rejected this offer, claiming that it was woefully insufficient and, in the light of the country's most recent growth figures, below the capacity of the country to repay. The creditors also strongly lobbied the G7 which, directly and through the IMF, put pressure on Argentina to improve its offer.[136] With pressure mounting from these quarters, Argentina turned to domestic pension funds with an offer of inflation-linked bonds that represented an improvement over the offer made to the other bond holders. By thus granting these institutions preferential conditions, Argentina was able to reach agreement with creditors holding more than 17 per cent of its total debt. This was a critical first step in garnering the support of a majority of creditors that eventually totaled 76 per cent. However, the offer of preferential treatment to domestic pension funds would not have been compatible with the principle of National Treatment.

4. Creation of a Privilege for the Debt Owned (or Acquired) by Creditors from the Party

Application of National and MFN Treatment only to creditors of countries that are parties to bilateral investment treaties (which have in recent years largely replaced the FCN treaties mentioned earlier) would have the discriminatory result of granting seniority to creditors from such countries over those from other countries. This would affect the rights of bond-holders from non-party countries without their consent since they are, by definition, excluded from intervening in the negotiations under the bilateral agreement. For these bond-holders such treatment might be equated to an involuntary debt swap under which they find themselves holding a downgraded instrument.

D. Investor-State Lawsuits and Sovereign Debt

One effect of applying the principles of investment treaties to sovereign debt is that Governments that violate investor protections can face expensive lawsuits. As under NAFTA and numerous bilateral investment treaties, CAFTA grants private foreign investors the right to bypass domestic courts and sue Governments in international tribunals (Peterson, 2004: 3).

Such “investor-state lawsuits” are highly controversial for a number of reasons (Peterson, 2004 and 2004a). Many arbitration tribunals operate with a lack of transparency, having no obligation to disclose relevant documents or allow any form of public participation. The system for choosing arbitrators has also drawn criticism as the arbitrators can be drawn from the ranks of practicing investment lawyers and there is no obligation to appoint arbitors who will be independent in the sense of not having a stake in how the treaty is interpreted.

Moreover, arbitral tribunals do not have to pay regard to legal precedents (Peterson, 2004: 6). This feature, which creates a lot of uncertainty in the investment arena, could become particularly troublesome when applied to sovereign debt crises. Indeed, the main rationale for more systematic arrangements for handling sovereign debt defaults has been the need to provide greater predictability for both debtors and creditors in the messy process of exiting sovereign debt crises. Clearly, the existing system of arbitration tribunals would do a poor job at addressing those concerns and would inject additional uncertainty into existing arrangements for the following reasons:

[136] In its IMF agreement the Argentine government had promised to “negotiate in good faith” and was singled out in some G7 statements as not complying with such a pledge. Private creditors maintained that negotiations in good faith required the agreement of 80 per cent of creditors, while the government of Argentina claimed that a figure above 65-70 per cent would suffice. It was incongruous that the IMF and G7 countries, which were themselves amongst the creditors, should have unilaterally attempted to define the conditions of an acceptable debt restructuring.

- The application of the principles of National Treatment and MFN to sovereign debt might give these arbitral tribunals the authority to define difficult questions that arguably belong to the domestic jurisdiction of states.
- The application of these principles might also open the way for the application of other more general principles that are becoming common in investment treaties, such as “minimum standard of treatment” or “fair treatment. As illustrated above in the discussion of Argentina’s debt renegotiation, there is no rules-based framework to determine what is an “acceptable” level of repayment or “negotiation in good faith”, etc. in debt negotiations and restructurings. Nor is there any certainty that principles or rules originally formulated in the context of bankruptcy law will be applied by an arbitration tribunal.
- These general principles are contentious even in the context of investment treaties. That minimum or fair standards of treatment apply only to investors, while considerations involving workers and other human rights as well as the environment, which might counterbalance them, are not given equal weight is a source of controversy.
- Closely related to points raised in section C.2 is the point that application of these general principles to sovereign debt would not take account of the responsibility of the Government of the debtor country to its population.

E. Concluding Remarks

The existing regime for dealing with sovereign debt crises lacks a rules-based, multilateral framework. This leaves debtors vulnerable to power asymmetries as compared with creditors. These asymmetries would be reinforced by extension of the definition of the investment instruments covered in bilateral investment treaties to include all or most debt instruments, particularly those for sovereign debt. There have already been moves towards a more inclusive definition of investment in some recent treaties. This has the consequence that debt instruments are subject to principles such as National Treatment and MFN Treatment which were originally developed to handle problems arising under bilateral investment treaties and goods trade under the GATT, and not debt crises. A notable exception to the recent tendency for extending such principles to debt is the NAFTA, which explicitly excludes sovereign debt from the definition of investment. In view of the dangers to developing countries from the extension of principles designed for foreign investment and goods trade to debt instruments, the NAFTA approach furnishes a superior model for the future.